Welcome to

Webinar #9: **Linking Cap-and-Trade Programs**

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11:30 am - 1:00 pm PST
12:30 pm - 2:00 pm MST
1:30 pm - 3:00 pm CST
2:30 pm - 4:00 pm EST

Linking Cap-and-Trade Systems

"The Good, The Bad, and The Ugly"

Cap-and-Trade Webinar
February 12, 2008

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Core Linking Principles

- Environmental Integrity
- Institutional Compatibility
- Economic Efficiency
- Equity

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Elements of a Linking Deal

- **The Bad**
  - Probable deal-breakers
- **The Good**
  - Where consistency probably matters
- **The Ugly**
  - Where inconsistency is okay

The Bad

- **Design elements that create an emissions "loophole"**
  - Price cap "safety valves"
  - Borrowing against *undefined* future commitment periods
  - Ex-post adjustment provisions
  - ~~Intensity-based emissions caps?~~
  - Leakage?

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The Good

- **Comparable stringency and mechanisms for compliance**
  – Stringency of emissions caps
  – Governance and enforcement systems
  – M&V standards and data quality
  – Compliance penalties and procedures
  – Banking and borrowing provisions
  – Offset rules and policies
  – Registry systems

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The Ugly

- **Coverage and distribution of emissions obligations**
  - Sectoral coverage
  - Allocation methods
  - Load-based vs. source-based coverage
  - Commitment periods
  - New entrants and closure provisions
  - Rules for opt-outs / opt-ins

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Conclusions

- Details Matter
  - Some “deal breakers” may not be serious
  - Some coverage & distributional issues may be real issues
- Political acceptability is the bottom line
- Getting to a deal will require mutual confidence across a wide range of technical design elements
- But for most elements, “close enough” is probably good enough

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Linking cap and trade systems

Damien Meadows

Deputy Head of Unit

DG Environment

European Commission

Legal basis for linking the EU ETS

- Art 25(1): agreements should be concluded with third countries listed in Annex B to the Kyoto Protocol which have ratified the Protocol to provide for the mutual recognition of allowances between the Community scheme and other greenhouse gas emissions trading schemes in accordance with the rules set out in Article 300 of the Treaty.

- Where an agreement referred to in paragraph 1 has been concluded, the Commission shall draw up any necessary provisions relating to the mutual recognition of allowances under that agreement in accordance with the comitology procedure referred to in Article 23(2) of ETS Directive.

Linking with systems in non-Kyoto countries

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Recital 18 of the Linking Directive:

Commission should examine whether* it could be *possible to conclude agreements* with countries listed in Annex B to the Kyoto Protocol which have yet to ratify it, to provide for the recognition of allowances *between the Community scheme and mandatory GHG ETS capping absolute emissions established within those countries

Possible candidates

- **iCAP members**
- **US Regional Greenhouse Gas Initiative (RGGI)**
- **California ETS and Western Greenhouse Gas Initiative**
- **Australian States and Territories**
- **Possible federal schemes in Australia and US**

Issues for linking agreements

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Of more importance

- Currency used and its status (AAUs, EUAs, ERUs, CERs, RMUs)
- Type of target/cap (absolute/relative - voluntary/binding) and stringency
- Quality of monitoring and reporting provisions
- Level and types of sanctions
- Extent of governmental intervention (caps/ safety valves/ex-post adjustments)
- Direct vs. indirect approach / Upstream vs. downstream
- Banking and borrowing
- Communication between registries

Of lesser importance

- Sector and gas coverage
- Trading periods
- Allocation method

Aviation

- Commission proposal in 2006 to include aviation in the EU ETS from 2011
- COM proposed to cover intra-EU flights initially and all flights arriving in or departing from the EU from 2012, EP favours all flights covered from 2011, Council all from 2012
- Arriving flights to be excluded if country of departure has taken sufficient action (e.g. emissions trading/ taxation)

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Key international aspects of the EU ETS revision

- EU's overall objective: to limit global warming to 2° C above pre-industrial levels
- EU wants an international agreement on achieving these levels of emission reductions
- This will requires contributions from developed countries and major emitting developing countries
- Climate / energy package provides incentives for others to join an international agreement

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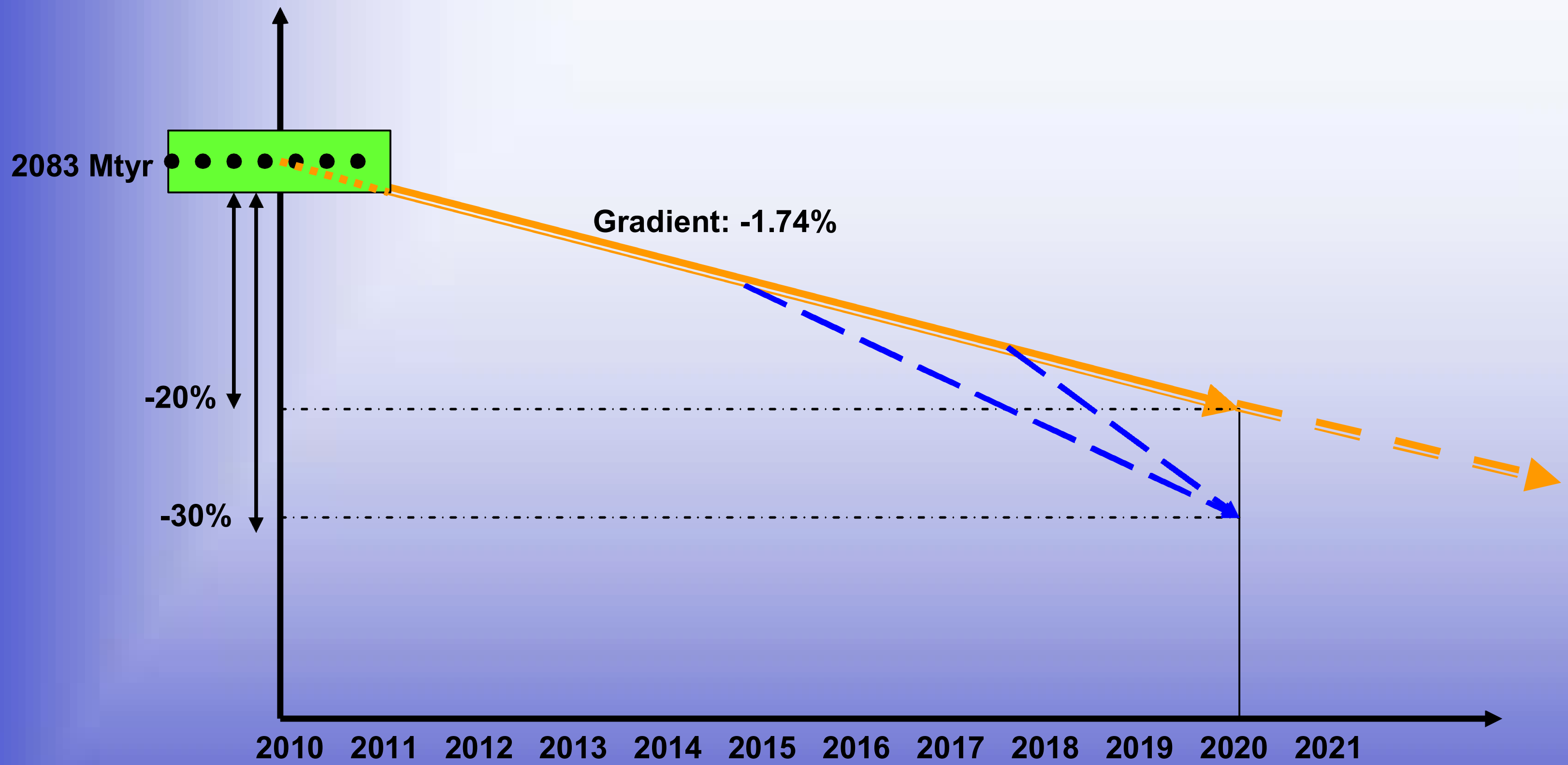
EU revision - Cap setting

- A single EU-wide cap to be agreed in co-decision rather than 27 caps proposed by Member States
- CO_2 allowances available in 2020 (based on current scope): 1720 Mt
  - - 21% compared to 2005 emissions
- Linear decrease
  - predictable trend-line to 2020 and beyond (annual decrease by 1.74%)
  - review by 2025
- Automatic adjustment to greater reduction foreseen in international agreement
- Aviation being included, building on December's Council political agreement

Cap setting


2083 Mtyr
Gradient: -1.74%
-20%
-30%
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
2021

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Allocation principles

- Harmonised allocation rules to ensure a level playing field across the EU:
  - No distortion of competition
  - No state aid risks for operators
- Auctioning as the general rule with transitional free allocation
- In terms of allocation rules, three categories of operators:
  - No free allocation (i.e. full auctioning)
  - Partial free allocation
  - Up to 100% free allocation
- European Commission to report on carbon leakage by 2011 and make any appropriate proposal:
  - To review free allocation levels and/or
  - To introduce system to neutralise distortive effects
  - Binding sectoral agreements to be taken into account
  - In conformity with principles of UNFCCC and WTO

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Linking

- Currently, EU ETS covers 30 countries including Norway, Iceland and Liechtenstein
- Linking agreements can be concluded any other third country listed in Annex B to the Kyoto Protocol which have ratified the Protocol (Australia, Canada, Japan, Monaco, New Zealand Russia, Switzerland, Ukraine)
- In revision, Commission proposes to enable EU ETS to also link with other mandatory emission trading system capping absolute emissions:
  - with any third country, or
  - in sub-federal and regional systems
- Different types of linking arrangements foreseen:
  - Treaty arrangements
  - Agreements to link systems
  - Reciprocal commitments applied through domestic systems

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Joint Implementation and the Clean Development Mechanism

- Links EU ETS with projects in around 150 other countries that have ratified Kyoto Protocol, by providing for companies to use JI/CDM credits for compliance in EU ETS
- Revision proposal gives <u>certainty</u> on the potential for companies to use JI/ CDM, <u>whether or not</u> there is an international agreement following Kyoto
- Clear need to differentiate between EU's <u>independent</u> 20% commitment to reduce GHG emission, and the contribution that the EU will make under an international agreement where others are also contributing, e.g.
  - JI/CDM are an incentive for third countries to join international agreement
  - Demand for CDM only from the EU would reduce market-based incentive to increase energy efficiency, investment in low carbon technologies
  - EU's renewables target would become more expensive if EU ETS not contributing to its achievement

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JI/ CDM use without international agreement

- Revision proposal ensures that:
  - JI/CDM credits can be used up to 2020, by enabling these to be exchanged for allowances
  - JI projects can continue beyond 2012, by enabling bilateral/ multilateral agreements with third countries
- In a -20% scenario, certainly is given for a total 1.4 billion tons for 2008-2020 (one third of reduction effort over the period) to:
  - Credits for reductions in the 2008-12 period from project types which were accepted by all Member States
  - Credits for reductions from 2013- from such projects set up in the 2008-12 period
  - In addition, credits from such projects from 2013- in any of the 50 Least Developed Countries
  - And credits from any bilateral/ multilateral agreements with third countries

JI/ CDM once international agreement

- Once an international agreement is concluded, the EU ETS will automatically increase the use of credits (JI/ CDM/ other) by 50% of the additional reduction effort under that agreement
- Member States' use of JI/ CDM/ other credits will also increase by 50% of the additional non-ETS reduction effort under that agreement
- This provides a clear incentive for third countries to join international agreement

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Conclusions

- Main objective: reduce greenhouse gas emissions - to do so at least cost
- Linking interesting for political, economic and environmental reasons
- Need compatible design features
- EU has gained first-hand experience on the kind of harmonised components that are desirable for a functioning system
- EU ETS revision will ensure a significant contribution by EU ETS to overall targets and provides a predictable and reliable long-term perspective for economic actors to take the necessary investment decisions
- Enables linking to any other mandatory system placing a limit on absolute emissions, and maintains incentives for others to join in taking action to address climate change

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